STATEMENT OF DIRK J.J. SURINGA
BEFORE THE COMMITTEE ON WAYS & MEANS
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE NEED FOR COMPREHENSIVE TAX REFORM TO HELP AMERICAN COMPANIES COMPETE IN THE GLOBAL MARKET AND CREATE JOBS FOR AMERICAN WORKERS

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Chairman Camp, Ranking Member Levin, and Members of the Committee:

My name is Dirk Suringa. I am a partner with the law firm of Covington and Burling LLP. From 2000 to 2003, I was an Attorney-Advisor in the Office of International Tax Counsel at the Treasury Department. I appreciate very much the opportunity to testify today before the Committee. I appear before you today on my own behalf and not on behalf of my firm or any firm client.

My testimony today is that of a practitioner who works daily with the existing U.S. foreign tax credit rules. The theme of my testimony is that if the United States does decide to pursue comprehensive tax reform, including the adoption of an exemption system for the relief of international double taxation, the United States should avoid letting the technically perfect system become the enemy of a perfectly good system. In this regard, the complexity of the current foreign tax credit rules offers a cautionary tale.

The United States uses the foreign tax credit as its primary method of relieving double taxation and has done so almost since the inception of the Internal Revenue Code.[1] As one might expect from a system that has been in place for over 90 years, the foreign tax credit rules have been repeatedly revised and have become exceedingly complex. The sources of complexity are varied, but their common denominator in my view can best be described as *the continual pursuit of technical perfection*. Trying to make sure that the rules operate as intended is of course a worthy goal for any set of tax rules, but in the case of the foreign tax credit, it has led over time to a system that makes comprehensive compliance and administration nearly impossible.

The operation of the foreign tax credit limitation, just one set of rules under the credit, offers many examples of this phenomenon. By way of background, the foreign tax credit limitation generally limits the amount of the foreign tax credit to the potential U.S. tax on a taxpayer's foreign-source income. The purpose of the limitation is to prevent the foreign tax credit from relieving a taxpayer of the U.S. tax that would otherwise be payable on U.S.-source income.

During the 1970s, Congress became concerned about the potentially distortive effect of capital gain and loss on the computation of the foreign tax credit limitation. If a taxpayer had foreign-source capital gain but U.S.-source capital loss, for example, then the taxpayer's foreign-source income would be increased, for purposes of computing the limitation,

[1] Pub. L. No. 65-254, 40 Stat. 1057 (1919).

without a commensurate increase in U.S. tax liability. A rule was therefore added to require taxpayers first to offset foreign-source capital gain against foreign-source capital loss. The remaining net foreign-source capital gain would be taken into account in the limitation only to the extent of the taxpayer's overall net capital gain.[2]

Congress also was concerned that foreign-source capital gains and losses were being taken into account for limitation purposes at their actual dollar amount, even though they bore a rate of tax less than that of ordinary income. Thus, if a U.S. taxpayer earned U.S.-source ordinary income and a foreign-source long-term capital gain, its foreign tax credit limitation could be artificially increased. Correspondingly, if a taxpayer incurred a foreign-source capital loss that offset U.S. capital gain, its limitation could be artificially reduced. Rules were therefore added to adjust the foreign tax credit limitation to account for the rate differential between capital gain and ordinary income.[3]

These rules, directed at enhancing the technical accuracy of the foreign tax credit limitation, also added an almost impenetrable thicket of rules and regulations, including separate definitions for terms such as "foreign source capital gain net income," "foreign source net capital gain," "capital gain rate differential," and "rate differential portion."[4] Thirty-five years later, unresolved interpretive questions remain and are unlikely to be resolved any time soon. And these rules represent only one very small example of the complexity that U.S. businesses must contend with on a daily basis.

A related consequence of the continual pursuit of technical perfection is instability in the foreign tax credit rules, which impedes long-term business planning. The history of the separate limitation rules again illustrates this phenomenon. At present, the foreign tax credit limitation is computed twice, once for so-called "passive category" income and again for all other income. This separate computation is intended to limit excessive cross-crediting. Cross-crediting is the practice of averaging high and low rates of foreign tax together to make the overall rate of foreign tax equal to or less than the U.S. tax rate, ensuring full utilization of available credits.[5]

The separate limitation rules have constantly changed over the history of the foreign tax credit: from no limitation (1918-1921), to a single "overall" limitation (1921-1932), to an overall limitation and a limitation applied separately to each country (a "per-country" limitation) (1932-1954), to a per-country limitation only (1954-1960), to an election to use either one (1960-1962), to an election plus a separate limitation for non-business interest income (1962-1976), to an overall limitation plus a single separate limitation for passive income (1976-1986), to an overall limitation plus multiple separate limitations (1986-2004), to its current status of an overall limitation with two separate limitations.

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[2] *See* I.R.C. § 904(b)(2)(A).
[3] *See* I.R.C. § 904(b)(2)(B).
[4] *See* I.R.C. § 904(b)(3); *see also* Treas. Reg. § 1.904(b)-1.
[5] *See* Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 862-63 (Comm. Print 1987). Foreign tax credits in excess of the limitation for a given year may be carried back one year and carried forward ten years, after which they expire.

This constant iteration is emblematic of the rest of the foreign tax credit system. Virtually every major piece of international tax legislation in the history of the Code has changed the foreign tax credit rules, including the enactment just last year of new Code sections 909, 901(m), 960(c), and 904(d)(6). Changes to the foreign tax credit rules, from ad hoc tweaks to wholesale revision, make long-term business planning difficult for U.S. businesses, relative to their foreign competitors.

The complexity and instability of the U.S. foreign tax credit rules impose a material, ongoing administrative burden on taxpayers and the government.[6] Comprehensive tax reform, such as the adoption of an exemption system for the relief of double taxation, offers the opportunity to clear away the detritus of past policy battles and to start anew with a simple and stable set of rules. Simply replacing one Byzantine system with another, however, will not help American companies compete in the global market or create jobs for American workers.

The oft-stated purpose of the foreign tax credit is to relieve international double taxation of income.[7] There is, however, another purpose for the foreign tax credit: to help U.S. businesses compete internationally. This purpose was openly acknowledged in earlier times. For example, in 1960 Congress authorized taxpayers to elect either the per-country limitation or the overall limitation for computing the credit, reasoning as follows:

> In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.[8]

In other words, American firms should be allowed to maximize their foreign tax credit through cross-crediting because that helps them to be competitive abroad.

Fast-forwarding to the present, U.S. taxpayers that buy foreign businesses now must contend with Code section 901(m), enacted in 2010. This provision denies the portion of the taxpayer's foreign tax credit attributable to foreign taxes imposed on the amount of foreign income that is not offset annually by the increased U.S. cost recovery deductions arising from differences in the treatment of the acquisition for U.S. and foreign tax purposes. In this case, as in many others before it, the pursuit of technical perfection has come at the cost of administrability—and, on a certain level, at the cost of encouraging U.S. businesses to buy foreign businesses, instead of the other way around. From one practitioner's perspective, simplicity, stability, and encouragement of U.S. businesses trying to compete with foreign businesses are critical design criteria in any system for the relief of double taxation.

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[6] *See* National Foreign Trade Council (NFTC), 1 *International Tax Policy for the 21st Century* 16 (2001); ABA Section on Taxation, Tax Simplification Recommendations 10 (2001).
[7] *Associated Tel. & Tel. Co. v. United States*, 306 F.2d 824, 832 (2d Cir. 1962); *Theo. H. Davies & Co., v. Commissioner*, 75 T.C. 443, 450 (1980), *aff'd per curiam*, 678 F.2d 1367 (9th Cir. 1982).
[8] S. Rep. No. 86-1393, at 4 (1960).